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The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC 01486-85

4 April 1985

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

FROM: David B. Low
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SUBJECT: A Decline of the Dollar: Some Policy Implications

1. Over the last two weeks the US dollar has declined sharply and is now about 10 percent below peak levels set in February. Despite the drop, the dollar remains about 30 percent above the rate analysts feel would restore the competitiveness of US goods in world markets.

2. Analysis done for the State Department [] shows that a 10 percent decline of the dollar will have only a moderate effect on inflation and growth. The decline will add about three-tenths of a point to consumer prices in the US in each of the next two years and cause somewhat larger reductions in inflation abroad (see attached table). Improved foreign sector performance will add slightly to US growth over the next year but cause reduced growth in European countries which have relied heavily on exports to the US for their recoveries.

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3. A more substantial decline of the dollar would raise some significant policy issues for the United States.

- Unless the European countries and Japan adopt stimulative economic programs to offset the impact on their economic growth rates of trade losses caused by appreciation of their currencies, global growth would decline with serious implications for LDC recovery.

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- For their part, foreign governments will watch closely the reaction of the Federal Reserve to temporary increases in inflation generated by the dollar's fall. A significant tightening of credit would also pose problems for the global recovery and LDC debt prospects.

4. Policy reactions in turn will depend in large measure on the circumstances surrounding a decline.

- A gradual convergence of growth and real interest rates between the US, Japan, and Western Europe with foreign growth improving and US growth moderating somewhat is viewed as an optimal scenario that could allow for a gradual fall in the dollar and carry the least potential for negative policy adjustment.
- A rapid decline in the dollar triggered by a US recession, on the other hand, carries perhaps the greatest potential for adverse policy reactions both by the Fed and major countries overseas. Without the stimulus of US growth, European governments would be even less likely to follow reflationary policies.

5. Over the last year, the more optimistic scenario has been unfolding, and continued bullish forecasts for US growth at a more modest pace give some analysts hope that this trend will continue. In the 12 years of floating rates, however, gradual currency adjustment and parallel movement of growth here and abroad has been the exception. Thus, based on past experience a major decline of the dollar under adverse circumstances remains the most likely outcome. Analysts disagree widely on the timing of any major decline, with many feeling the dollar will stay strong for several years.



David B. Low

Attachments:

Table: Effects of Dollar Decline

Attachment 1: Why the Dollar is High

Attachment 2: Impact of a High Dollar

State/INR Report: Implications of Dollar Depreciation

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**THE EFFECTS OF A 10 PERCENT DECLINE
IN THE DOLLAR ON GROWTH AND INFLATION ¹**

	<u>Real Growth</u>			
	Years: 1	2	3	4
EC	-0.9	+0.3	n11	n11
Japan	-1.0	-0.2	n11	n11
U.S.	+0.2	-0.2	n11	n11

	<u>Inflation</u> (consumer price deflator)			
	Years: 1	2	3	4
EC	-0.3	-0.6	-0.5	-0.5
Japan	-0.7	-0.5	-0.5	-0.3
U.S.	+0.3	+0.3	+0.2	+0.1

¹ Based on analysis for State Department

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ATTACHMENT 1

WHY THE DOLLAR IS "HIGH"

In its 1985 annual report, the Council of Economic Advisors cites two major factors for the roughly 60 percent rise in the dollar since 1980:

- Tight monetary policy in the 1980-82 period that led to the expectation that there was a very favorable real interest rate differential for investing in US dollars.
- Since 1982, the Economic Recovery Tax Act together with reduced inflation which significantly raised after tax rates of return on new business investments in the US. These higher rates, in turn, spilled over into financial investments in general.

The Council also points to a reversal of international lending outflow and generally favorable longer-run prospects for the US economy (presumably vis-a-vis Europe and most LDCs) as contributing factors in the dollar's rise. (This net inflow of capital results from a reduction in the level of outflows from the US. Foreign funds coming into the US have not increased significantly over the past few years.) The Council's report notes that expanding Federal budget deficits are often cited as a cause of high real interest rates but indicates that "numerous" studies have so far failed to uncover a significant relationship between deficits and the dollar's rate.

Debate over why the dollar is high centers around which of these factors is most important. Those who blame federal budget deficits argue that as long as the United States does not cover domestic investment with domestic savings, the need to import significant amounts of capital causes artificially high real interest rates and boosts the dollar. Others argue that recent declines in real interest rates in the US accompanied by an even stronger dollar show that it is the fundamental strength of the US economy that is attracting funds from abroad.

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ATTACHMENT 2

THE IMPACT OF A HIGH DOLLAR

- Data Resources (DRI), in recent testimony before the JEC, estimated the costs at 1.5 million jobs lost since 1980 and blames the high dollar for two-thirds of the deterioration in the US current account.
- An an indicator of lost competitiveness, DRI cites Japanese unit labor costs, which were nearly as high as US costs in 1978, and are now at a level of only 60 percent of those in the US because of the rise in the dollar.
- While this analysis takes account of jobs lost to foreign competition, it does not account for the jobs gained either directly as a result of the net inflow of capital or indirectly due the federal spending levels that are funded in part by these inflows.

Those analysts who argue that the high dollar is a result of the strong economy point to substantial investment growth as proof that the private sector is doing well despite the dollar.

- By late 1984, investment in producers durable equipment was running nearly 30 percent above the average for 1983.
- But this overall figure masks a relatively low rate of industrial investment.
- Furthermore, 25 to 30 percent of purchases of durable equipment (exclusive of automobiles) are now filled by imports, up from 15 percent only 3 to 4 years ago.
- What we are probably seeing is a massive shift in investment toward services and defense-related industries with a large decline in investment in those industries that must compete with firms overseas.

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